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STATE FOR SCA/INS AND EB/IFD/OMA
TREASURY FOR LESLIE HULL

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TAGS: ECON EFIN EAID CE
SUBJECT: SRI LANKA: INFLATION 17.5% IN 2007; CENTRAL BANK SAYS
10-15% IN 2008

REF: A. 07 COLOMBO 1661 B. 07 COLOMBO 1639

¶1. (SBU) Summary and comment: Sri Lanka's inflation remained high in 2007, averaging 17.5% for the year after spiking to around 20% at times. Consumers and business both felt the impact, with food and fuel prices rising most steeply. Correspondingly high interest rates compounded the pain. The government blames rising oil and other imported commodity prices, but the IMF states the government's high deficit spending was the primary driver of the inflation. The Central Bank aims to bring inflation down to 10-11% by the end of 2008, but concedes that continued high fiscal deficits or further oil price increases could make this impossible. The government is trying to control prices rises by resuming subsidies it had recently stopped and by attempting to import and distribute "essential commodities" more cheaply than the market can. These efforts are likely to add to the deficits that are driving much of the inflation. End summary and comment.

INFLATION 17.5% IN 2007

¶2. (SBU) Sri Lanka experienced a second straight year of high inflation in 2007, with a 17.5% average 12-month increase in the Colombo Consumer Price Index. The 2006 rise was 13.5%. Both these figures exceed the 12% average annual inflation Sri Lanka has experienced over the last 30 years. The government blamed high oil and imported commodity prices as the main causes of the high inflation. However, according to both the Central Bank's research department and the IMF, inflation in Sri Lanka is largely a fiscal phenomenon with government deficit spending responsible for about half of the inflation. The Central Bank calculated that rising prices of imported goods caused only about a quarter of the inflation. Another major factor was Sri Lanka's removal or reduction of subsidies on fuel, cooking gas, and wheat. A final factor was the government's imposition of increased taxes and other levies on most imported goods (ref A).

CONSUMERS AND BUSINESSES BOTH HURTING

¶3. (U) In 2007, prices of most basic foodstuffs such as bread, wheat flour, rice, sugar, lentils and milk powder skyrocketed. Prices of bread and wheat flour, now consumed as widely as rice, increased most -- by over 80%. Energy and fuel prices have also increased, due to reduced subsidies. Electricity went up by about 14%,

gasoline by over 25%, and cooking gas by over 130%. As a result of these increases, expenses such as bus fares, shipping, and construction costs also rose significantly in 2007.

¶4. (SBU) Inflation and correspondingly high interest rates have hit businesses as well. Lending rates to prime customers currently average 19.3%. Other customers face higher rates. To reduce their exposure to inflation, banks have begun limiting their commercial and personal loans to short durations, typically just a few months. According to a business confidence index published by Lanka Monthly Digest, 76% of companies surveyed in December 2007 reported declines in business in the previous three months. Over 53% experienced a sales downturn in the previous twelve months. Two major conglomerates reported sales declines in their retail, food, and agricultural products divisions. The high interest rates have also hurt a previously hot real estate market, with condominiums especially seeing a severe drop in sales.

¶5. (U) Inflation has also generated wage pressures throughout the economy. Workers in several sectors including education, health care, apparel production, and plantations pressed for wage hikes in ¶2007. The President mandated a wage increase to plantation workers in October 2007. A number of unions have stated they will strike in 2008 if their members do not receive higher pay.

NEW PRICE INDEX REGISTERS SIMILARLY HIGH INFLATION

¶6. (U) The Government launched a new consumer price index, the Colombo Consumer Price Index-New (CCPI-N), in November 2007. The old CCPI had tracked the same basket of goods since 1952 and was therefore no longer a good measure of inflation. The new index is based on a 2002 consumer finance survey and has a lower weight for

food and a higher weight for electricity, fuel, and modern consumer items like cell phones. Despite the revision, the CCPI-N, if applied retroactively for all of 2007, would have indicated comparably high inflation -- an average of 15.8% for the year versus the 17.5% using the CCPI. (Note: Post will use the new index for reporting future inflation figures.)

MONETARY POLICY TO REMAIN TIGHT, BUT CANNOT DO IT ALL

¶7. (SBU) In a January 2 presentation to bankers, business leaders, and diplomats entitled "Road Map: Monetary and Financial Sector Policies for 2008," Central Bank Governor Cabraal spelled out the Bank's goals for 2008. In this second annual road map presentation, the governor said this "new tradition," would assist the financial sector to "synchronize [its] economic decisions with...national goals." He explained that the Central Bank uses monetary targeting -- attempting to control the growth of the money supply -- to achieve price and economic stability because it lacks the policy levers to conduct inflation targeting.

¶8. (SBU) According to Cabraal, in 2007 the Central Bank raised its "repurchase" rate for overnight bank borrowing by 50 basis points to 12%, one of the highest policy rates in the region. Because this rate was below the rate of inflation, the Bank also attempted to contain market liquidity by limiting the number of times commercial banks could turn to the Central Bank for overnight or other short-term credit. Despite these efforts, the money supply increased by 18% compared to a planned 14.8%. This was primarily a result of heavy borrowing -- to cover deficits -- by government and government corporations from the Central Bank and from commercial banks. The government borrowing both added to the money supply and drove market interest rates up to around 20%.

2008 GOAL OF 10-11% INFLATION MAY BE HARD TO REACH

¶9. (SBU) Cabraal stated that the Central Bank's 2008 monetary program was designed to accommodate real GDP growth of 7.0%. (Note: The government's 2008 budget figures were based on projected 2008 GDP growth of 7.5% (ref A). Cabraal's was the first admission that the GDP projection was unrealistic.) Reserve money is to increase

by 15% and broad money by 17% in 2008. The Bank expects a net repayment of loans by state entities and a decline in new credit to state corporations for the year -- in part, he stated, due to Iran's "highly welcome" extension of credit to Sri Lanka for seven months worth of oil purchases (ref B). Credit to the private sector is expected to increase, but more slowly than it did in 2007. These targets, according to Cabraal, would bring inflation down to 10-11% by the end of 2008. He acknowledged that inflation could easily come in at 12-14% if oil prices remain over $90 per barrel, if Sri Lanka experiences an escalation of terrorism, or if the government's deficit is larger than planned.

GOVERNMENT FISCAL RESPONSE - REINSTITUTE SUBSIDIES
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¶10. (SBU) The government has responded to rising prices mainly by trying to control them administratively or with subsidies. It has come to an agreement with the main association of commodity importers and traders to control wholesale prices of ten "essential" food items: the government will remove import taxes on these products in exchange for the dealers agreeing to hold down prices correspondingly. The government also administers prices for a number of products like fuel, cooking gas, milk powder, and wheat flour; with inflation high, it routinely delays approval of sellers' requests for permission to increase prices in line with market prices. The government has also resumed subsidizing fuel prices, abandoning its mid-2007 decision to permit prices to adjust with global market prices. Finally, the government says it will revive a previously failed program for the state to import food and sell it at cost through state-run retail and wholesale outlets.

POLITICAL REACTIONS -- BLAME THE GOVERNMENT

¶11. (SBU) The opposition United National Party has sought to capitalize on public dissatisfaction with the high inflation. In 2007, the UNP organized several anti-government rallies around the

country, at which the cost of living increases were a central criticism. The UNP has also started visiting village fairs distributing pamphlets about the rising cost of living. The populist JVP has also held rallies against the rising cost of living.

COMMENT: GOVERNMENT WON'T ADMIT IT IS THE PROBLEM
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¶12. (SBU) Sri Lanka's 2007 inflation far exceeded that of other South Asian countries, some of which are also heavy importers of essential commodities. Also, prices of many locally produced commodities rose steeply. For example, coconut rose 27% and rice over 20%. These facts further reinforce the IMF's conclusion that the government's deficit spending, not just the worldwide rises in commodity prices, drove the high inflation. The government's efforts to address the inflation problem -- subsidies, small tax reductions, and promises of government distribution channels -- have been designed for political value: to enable politicians to tell voters "we are doing something." Worse, each of these will add to the persistent deficit, which is the main cause of the inflation, so will obviously not solve the problem. Moreover, continued high government borrowing and increasingly entrenched expectations of inflation will keep interest rates high, crowding out private sector investment, which is more productive than government spending. The result eventually will be lower real growth rates than the relatively healthy 6-7% growth Sri Lanka has been achieving lately.

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